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What You Need to Know Before You Receive an Unsolicited Bid

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The flow of hostile bids has remained moderate, but steady during recent years. To be certain, directors, senior executives and M&A professionals are no longer operating under the illusion that an unsolicited offer is just a bad dream from the 1980s.

Despite the enduring presence of hostile bids, U.S. public companies continue to dismantle their defensive protections against such hostile bids. As proxy advisors' clout has expanded, and institutional investors have become more actively engaged in the business and affairs of companies than ever before, many companies have concluded that the potential for barbarians at the gate is less troublesome than the darkening clouds of public scrutiny. No company wants to be seen as ignoring good corporate governance or best corporate practices.

Looking forward, however, corporate leaders and their advisors cannot simply ignore significant vulnerabilities or roll over in the face of inadequate offers. Indeed, numerous hostile takeover situations from this past year have demonstrated that antitakeover defenses are alive and well, and available to be deployed in the face of hostile overtures.

The Battleground of the 1980s

In the 1980s, as dynamic junk bond markets helped to facilitate a major upsurge in takeover transactions, corporate raiders wielded their battle-axes throughout all economic sectors. Hundreds of underperforming and undervalued companies found themselves in the crosshairs and ultimately lost their independence.

Of course, long before this flurry of activity, many States had already enacted laws aimed at regulating takeover bidders. From a political perspective, many elected officials perceived hostile takeovers as a direct cause of lost jobs, for which no politician wanted to be responsible. After Virginia enacted the first takeover statute in 1968, 36 states followed over the next 13 years.[1] These takeover statutes were designed to strengthen the feeble defensive posture of vulnerable corporations, generally imposing affirmative requirements (such as advance notice) and limitations on tender offers.

However, in 1982, the United States Supreme Court struck down Illinois' antitakeover statute, holding that the state interests asserted in support of the statute were insufficient to justify the burdens on interstate commerce that it imposed.[2] The Court was unable to rationalize the statute's extraterritorial reach with the Commerce Clause,[3] indicating that "the most obvious burden the Illinois Act imposes on interstate commerce arises from the statute's previously described nationwide reach which purports to give Illinois the power to determine whether a tender offer may proceed anywhere."[4] The Court found this burden to be "substantial" because stockholders were "deprived of the opportunity to sell their shares at a premium," which hindered "the reallocation of economic resources to their highest valued use, a process which can improve efficiency and competition."[5]

And so, with statutory defenses unavailable, many companies were at the mercy of raiders like Carl Icahn, T. Boone Pickens and Asher Edelman. In response, the New York M&A Bar formulated numerous takeover defenses that were adopted by many U.S. corporations.[6] For instance, under a "classified" or "staggered" structure, a board of directors was divided into three classes, only one of which is up for election each year. As a result, a hostile bidder seeking to launch a proxy contest would be unable to replace the entire board in one year. Of course, it is possible that a bidder successfully replacing one-third of a target board would be able to exert influence inside the boardroom and prevail upon the continuing directors to approve the proposed takeover. Nevertheless, the classified board structure bolstered a target's negotiating posture and helped directors obtain a higher transaction price for stockholders.

A stockholder rights plan, commonly known as a "poison pill," can further strengthen the armor of potential targets. A rights plan typically provides that if a bidder acquires more than a specified portion of the target's stock without prior board approval, all of the target's existing stockholders (excluding the hostile bidder) will have the right to buy newly issued target stock at a significant discount.

Courts quickly blessed rights plans as legitimate antitakeover devices.[7] The decision of a board of directors of a Delaware corporation to adopt a rights plan (or to refuse to redeem a plan that has already been adopted) in response to a purported corporate threat will generally be permissible if (1) the board had reasonable grounds to believe that the purported threat posed a danger to corporate policy or effectiveness and (2) the board's action was not draconian or preclusive and was proportional in response to the threat.[8]

In any event, a rights plan cannot permanently prevent a hostile takeover, since a hostile bidder can always solicit proxies to replace recalcitrant directors and redeem the rights. But, at the very least, the existence of a rights plan can provide directors with additional time to evaluate strategic alternatives.

Defenses Weaken But Threats Remain

Last year's well-publicized *Airgas* decision by the Delaware Court of Chancery affirmed that the one-two punch of a staggered board and a shareholder rights plan is a legitimate defensive measure.[9] Applying *Unocal*, Chancellor Chandler found that the Airgas board of directors had

made a good faith and reasonable investigation in connection with Air Products' offer,[10] had reasonable grounds to conclude that Air Products' offer constituted a legally cognizable threat to Airgas, and, in continuing to stand behind the rights plan, made a proportionate response that, even when coupled with the staggered board, was nonpreclusive. Although Chancellor Chandler seemed to pause with some hesitation over the question of substantive coercion[11]—the idea that shareholders may be inclined to accept an inadequate offer due to ignorance or a mistaken belief in the deal's strategic benefit[12]—he noted that the Delaware Supreme Court has rejected an application of *Unocal* that "would involve the court in substituting its judgment as to what is a 'better' deal for that of a corporation's board of directors."[13]

However, despite the judicial acknowledgement of the legal legitimacy of rights plans and the track record displaying their efficacy, companies are electing in droves not to maintain them.[14] In addition, many newly-adopted rights plans have been put in place for the purpose of protecting NOLs,[15] rather than to ward off raiders refusing to pay adequate control premiums.[16] The highly-influential proxy advisory firm Institutional Shareholder Services ("ISS") has taken the position that rights plans should contain the following attributes:[17]

- At least a 20% trigger;
- A term of no more than three years;
- No dead-hand, slow-hand, no-hand or similar feature that limits the ability of a future board to redeem the rights plan; and
- A shareholder redemption feature (*i.e.*, a qualifying offer clause).

Likewise, declassification of boards of directors is on the rise. More than half of S&P 1500 companies now have declassified boards.[18] Highlighting the mounting shareholder pressure, a study of the 2012 proxy season found that 80.2% of votes cast on proposals to eliminate classified boards were cast in favor, and that 87% of all such proposals that went to a vote ultimately passed.[19]

Nevertheless, as *Airgas* made clear, corporate defense mechanisms, including the existence of a staggered board and the adoption of a rights plan, represent viable instruments with which a board of directors may protect its company and shareholder interests. Carl Icahn's recently failed takeover of Oshkosh Corporation is an instructive example of the utility of these devices to defend against corporate threats. Mr. Icahn opened 2012 with a proxy contest but was unable to convince Oshkosh's shareholders to elect any of his nominees. Undeterred, Mr. Icahn launched a tender offer in October and geared up for another proxy fight.[20] In response, the Oshkosh board adopted a rights plan and recommended that shareholders reject Mr. Icahn's tender offer. Ultimately unable to meet his 25% tender threshold, Mr. Icahn dropped his tender offer and campaign for board control.

Another hostile takeover drama from 2012, GlaxoSmithKline's pursuit of Human Genome Sciences, demonstrated the effectiveness of takeover defenses in generating shareholder value. In May, GSK launched an all-cash tender offer for $13.00 per share, and Human Genome's board promptly adopted a rights plan and recommended that shareholders reject GSK's offer. Having secured additional time to negotiate, Human Genome's board convinced GSK to increase its price to $14.25, and the deal ultimately closed on a consensual basis.

To be certain, recent hostile situations have underscored the primacy of the poison pill as a first line of defense. Illumina Inc. fended off Roche by adopting a rights plan and scoring tender offer and proxy contest victories. In August, Forest Laboratories, Inc. adopted a rights plan that, so far, has slowed Carl Icahn's advances. Mr. Icahn has also turned his attentions to Netflix, which, in response, adopted a rights plan in early November.

Be Prepared

Although dropping corporate defenses is highly in fashion, a board would be well-served to keep a rights plans on the shelf and a keen ear to the ground for any potential suitors or investor relations issues. The following is an overview of certain measures that can be taken to maintain preparedness:

- *Be vigilant*. A board should ensure that it and the company's management team remain vigilant for any warning signs that a takeover attempt may be brewing. Any approach to the company should be discussed, and potential ramifications evaluated.

- *Assess vulnerabilities*. A board should regularly evaluate its company's particular circumstances and any risks to which the company may be exposed. Considerations may include the attractiveness of the company's balance sheet to a potential acquiror (*e.g.*, significant NOLs or strong cash flow vs. little debt); the pending implementation of a new strategic plan; or a depressed stock price vs. future prospects.

- *Tailor structural defenses to perceived threats*. If a board believes its company's share price is not fully valued, or that the company otherwise may be vulnerable to a hostile bid, then the board should consider whether to make adjustments to its defensive position. In addition, the board may proactively consider strategic alternatives, such as a recapitalization or share repurchase, a sale of assets or a negotiated change of control transaction with a third party.

- *Keep a rights plan on the shelf*. If there is no active rights plan in place, the board should work with its legal advisors to maintain a draft plan that can be swiftly adopted if a threat suddenly arises.

- *Maintain good investor relations*. A board should ensure that its investor relations team is fully attuned to shareholder perspectives and concerns. Regular interaction with shareholders can help foster investor satisfaction and uncover potential threats.

- *Build a crisis protocol*. A board should have a formulated plan for dealing with a crisis, including procedures for calling and holding emergency board meetings, and it should be prepared to assemble quickly a small group of directors or members of management who can be delegated with sufficient authority to take nonfundamental actions without full board sign-off. The board should maintain an active dialog with its legal and other advisors.

Of course, with respect to defensive tactics, there is no definitive, one-size-fits-all approach. Certainly, this past year has demonstrated the utility of a shareholder rights plan, either as a tool to buy time and negotiate a higher offer or, ultimately, as part of broader array of strategies to impede an takeover attempt that undervalues the target company. When coupled with a staggered board, a rights plan can effectively force hostile bidders either to (i) offer a price that the target board deems sufficient, (ii) win multiple proxy contests in order to take control of the target board, or (iii) abandon the takeover. The takeaway lesson going forward? If you do drop your shield, keep it close at hand.

NOTES

1. R. Grant Decker Jr., "Kneeling to the SEC Rules: The Virginia Takeover Act and SEC Tender Offer Rule 14d-2(b)," 22 *Wm. & Mary L. Rev.* 487 (1981).
2. *Edgar v. MITE*, 457 U.S. 624 (1982).
3. "[The] Commerce Clause . . . precludes the application of a state statute to commerce that takes place wholly outside of the State's borders, whether or not the commerce has effects within the State." *Id.* at 642-43.
4. *Id.* at 642.
5. *Id.* at 643.
6. Common takeover defenses include staggered boards, antigreenmail provisions, supermajority voting, fair price provisions, advance notice requirements, caps on the number of directors, only permitting directors to be removed for cause, disallowing stockholders' ability to call special meetings, requiring any actions by written consent to be signed by all stockholders, and eliminating preemptive rights and cumulative voting.
7. *See, e.g., Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985).
8. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) and *Unitrin, Inc., Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995).
9. *Air Products & Chemicals, Inc. v. Airgas, Inc., In re Airgas Inc. Shareholder Litigation*, 16 A.3d 48, 100 (Del., Ch. 2011).
10. Chancellor Chandler noted that the board consulted legal counsel and independent

deals will not be easy, but they will most certainly be interesting.

financial advisors, with three directors who had been elected to the Airgas board upon nomination by Air Products separately retaining their own set of legal and financial advisors. *Id.* at 103 *et seq.*

11. Arbitrageurs (who by definition are not interested in long-term corporate policy and effectiveness but, rather, short-term profits) took significant positions in Airgas' stock, and the board concluded that remaining shareholders may feel substantively coerced to tender the shares into the tender offer in order to go along with the pack. *Id.*
12. *See, e.g., Paramount Communications, Inc. vs. Time Inc.*, 571 A.2d 1140, 1153 (Del. 1990).
13. 571 A.2d at 1153 (citing *Time*).
14. *See* John Laide, "A New Era in Poison Pills–Specific Purpose Poison Pills," April 1, 2010 available at https://www.sharkrepellent.net/request?an=dt.getPage&st=1&pg=/pub/rs_20100401.html&Specific_Purpose_Poison_Pills&rnd=372936.
15. In *Versata Enterprises v. Selectica, Inc.*, 5 A.3d 586, at 607 (Del. 2010), the Delaware Supreme Court confirmed that the risk to a company's NOLs was a legitimate threat, and that the adoption of a rights plan was proportional in response.
16. Andrew L. Bab and Sean P. Neenan, "Poison Pills in 2011," *Director Notes Series*, Vol. 3, No. 5, 2011.
17. *See* Institutional Shareholder Services Inc., 2012 U.S. Proxy Voting Guidelines Summary (January 31, 2012), available at http://www.issgovernance.com/files/2012USSummaryGuidelines1312012.pdf.
18. Robert Yates and Bimal Patel, "ISS Releases 2012 U.S. Board Practices Study," March 2, 2012, available at http://blog.issgovernance.com/gov/2012/03/iss-releases-2012-board-practices-study.html.
19. John Laide, "Takeover Defenses Being Targeted in 2012," June 20, 2102, available at https://www.sharkrepellent.net/request?an=dt.getPage&st=undefined&pg=/pub/rs_20120620.html&Takeover_Defenses_Being_Targeted_in_2012&rnd=436706.
20. Mr. Icahn sought to pursue the proxy contest in order to remove impediments posed by Wisconsin's business combination statute. Similar to Section 203 of the Delaware General Corporation Law, Section 180.1141 of the Wisconsin Business Corporation Law, which is applicable to Oshkosh, would restrict 10% or greater shareholder from entering into certain types of business combination transactions with a company for a period of three years after the 10% threshold is crossed if the board of directors does not approve the acquisition or the specific transaction in advance.